

## CIT Executive Spotlight: The Second in a Series Focusing on Retail Financing Challenges & Opportunities in the Retail Sector with Burt Feinberg

The following conversation is the second in a series of discussions with CIT executives who serve as leading experts in the retail sector. This Executive Spotlight takes a closer look at the [challenges facing retailers today](#), the important [role the retail sector plays](#) in the U.S. economy, how retailers are [managing through the credit crisis](#) and the increased interest in [asset-based lending](#) in the current environment.

The inaugural Retail Financing Executive Spotlight focused on [Retail Trends](#) with [John Daly](#), President of CIT [Trade Finance](#). CIT Trade Finance is the #1 factoring company in the U.S., with more than \$7 billion in managed assets with customers in the U.S., Canada, Europe and Asia. CIT's factoring provides funding to thousands of small manufacturers which, in turn, sell to retailers that also rely upon CIT for the flow of goods into their stores.

### **Q: What are the major challenges retailers are facing in the current market?**

**A:** Retailers need to adjust their strategies or implement tactics in light of the huge drop-off in consumer spending. Until mid-2007, retailers had the wind at their back for several years with consumers overspending and over-borrowing. Aggressively growing stores and maintaining large inventories was the name of the game for many players to maximize sales and growth. Today, retailers need to focus on liquidity and preservation of capital, a quick reversal in thinking. Visibility as to when and how the consumer will come back remains unclear. The retailers with stronger balance sheets need to adjust strategies and tactics to maintain their position so that they can take full advantage of the recovery, while the weaker ones need to make sure they stay in business altogether.

### **Q: How significant is the retail sector to the U.S. economy?**

**A:** It is very important for the U.S. economy to see a rebound in retail. Not only is consumer demand a barometer of the health of the economy, but retailers are large employers. I recently read a report that said about 700,000 jobs have been lost in retail since March 2008. Retail employs 10% of the workforce in the United States and both provides long-term career opportunities and is a source of employment for students as well as seniors. It also provides interim employment for people as stepping-stones in achieving other career objectives.

### **Q: Has the economic downturn forced retail CEOs to think differently?**

**A:** Absolutely. In the short term, CEOs are now focused on liquidity. In the long term, CEOs got a huge reminder that retail is a cyclical business, and they are now acting accordingly. Looking back at their recent strategies, many CEOs are admitting that they may have been a bit aggressive on store growth and they



**Burt Feinberg is Managing Director and Industry Group Head for the Retail Finance group within CIT Commercial & Industrial. The group, which he has led for the past four years, is a leading provider of asset-based revolving credit facilities and cash-flow term financings to retailers and restaurants in the United States; in that capacity, it provides acquisition financing for equity sponsors, refinancing and growth financing, as well as DIP and exit facilities to retailers in turnaround situations.**

may have taken their eye off the ball in terms of controlling costs and driving efficiencies. In this economy, CEOs are now focused on operations, as they cannot depend on top-line growth to generate income. Suddenly, CEOs are finding the ability, out of necessity, to reduce costs and to take a harder look at how they do some of their blocking and tackling. They are also taking a hard look at their business model—Who is their customer? Do they offer value? Do they have too many vendors? Is there a more efficient distribution model?—basic self-examination.

So, tactically, in the short run, CEOs are reducing store growth and keeping inventories at conservative levels. Strategically, for the long run, they are looking at their cost structure and deleveraging to be sure that they are not as vulnerable as they were in 2008–09 to a falloff in demand. They are taking a more realistic view of store growth when the economy turns around. It is obvious, based on all the retail bankruptcies over the past 18 months, that America was over-stored.

**Q: American shopping habits have changed dramatically. How are retailers adjusting?**

**A:** There are many factors that have affected the American consumer. Some are longer-term changes in buying habits, and some factors are a function of depressed consumer confidence and the recessionary environment. On a long-term basis, the Internet has had a major impact as shoppers can shop price, do research online, and so on. You see the impact of this, for instance, in the electronics industry; a big-box store competes in this environment on price with special promotions and deep purchases of entry-level products from top brands, while a discounter offers customer service and breadth of product. Other players are being shaken out.

Many companies now have multi-channel business models—bricks and mortar, catalog, e-commerce and other direct-marketing techniques—so that they address all types of customers.

The current economy has caused a trading down in consumer purchasing. There has been a huge drop in the purchase of luxury goods, with the large luxury retailers experiencing approximately 20% declines in comp sales, not to mention huge discounting. Yet, at the same time, you see positive comps at some of the big-box retailers. Same type of phenomenon is true in the restaurant sector, with casual dining and white-tablecloth dining suffering large declines year over year and quick service holding its own. You also see those sectors of retail, whose products are mostly discretionary, suffering greatly, such as jewelry and furniture. Another change in buying habits is that the consumer now shops at all levels and sectors—it is not uncommon to see a consumer buy certain items at a top end retailer and some items at a discount store.

**Q: What's the future of luxury retail?**

**A:** There is a big debate as to whether luxury retail is dead. After the luxury consumer saw luxury retailers heavily discount goods at as much as 70% off, they are questioning the intrinsic value of these goods at full price. Psychology is a major factor in luxury, and even the wealthiest consumer is cutting back as their investment portfolios have diminished. This customer will eventually return, in my opinion, but the issue is whether the “aspirational customer,” now frugal and some not working due to layoffs in financial services, will return. It is this customer who contributed greatly to the really strong years in the luxury

“It is obvious, based on all the retail bankruptcies over the past 18 months, that America was over-stored.”

“The current economy has caused a trading down in consumer purchasing.”

sector. Many are predicting a prolonged, almost “depression” type of consumer mentality to prevail for a long time. Personally, I think that the luxury sector will come back, but the bigger issue is when, in what form, and which players will survive.

**Q: What retail models are surviving or even thriving in the current environment?**

**A:** The obvious models that are doing well are big-box value players, the discounters, and the value convenience players. In the apparel space, inexpensive and fast fashion retailers have a good business model for this environment. They turn inventories quickly and are aimed at a young audience delivering the latest trends while not over-committing deeply to any style, hence keeping risk low in what seems at face to be a high-fashion/high-risk business. Another model is the vertically integrated retail brand model. Control over production and uniqueness of product enable this type of company to avoid many of the pitfalls, most notably competitor price discounting, facing retailers that sell multi-branded merchandise. As I mentioned earlier, it is important to have a multi-channel approach in today’s retail world.

**Q: How do you identify creditworthy clients in this market?**

**A:** We look for all the metrics and trends one would associate with assessing the credit strength of a company. We look at trends like same-store sales growth, trends in margins, inventory levels year over year, and inventory levels relative to sales growth. We look at liquidity. We look at store-level profitability with an eye for patterns or trends as to which stores are performing well, how recent store additions perform compared to older, more established ones. Are accounts payable growing? At the end of the day, store-level performance and profitability is key and scale is important. SGA (selling, general and administrative expense) has to be in line with a company’s store cash flow. We also look at these metrics and compare them to competitors. We are razor focused on free cash flow and finding the balance between growing a business by investing excess cash flow in new stores versus preserving a sound balance sheet. About 80% of our Retail Finance portfolio is asset-based lending, where we are secured by inventory and other assets, so despite deficiencies in many of the metrics mentioned, we could still lend to a retailer if they have accurate reporting and inventory systems. Even if a company is burning cash, we could lend to a company to provide capital to support growth or to support a turnaround situation. Based on years of experience in our underwriting and new business teams, we have the ability to find distinctions in the collateral pools we lend against and structure prudent transactions accordingly.

**Q: Given the current uncertainty among retailers, what advantages does asset-based lending (ABL) have over other forms of lending in a recessionary environment?**

**A:** Since ABL loans are advanced against the assets of the company, and since there is a great history of lenders recovering their investment in ABL deals that fail, lenders are comfortable providing lines of credit that do not have financial covenants as long as there is a reasonable amount of excess availability or collateral coverage. Given the uncertainty in this environment, vendors and suppliers to the retail industry need to know that they will ultimately be paid for shipped goods. A retailer must have confidence it can meet its financial

“We are razor focused on free cash flow and finding the balance between growing a business by investing excess cash flow in new stores versus preserving a sound balance sheet.”

commitments, which fluctuate with its seasonal needs. ABL facilities, while requiring more comprehensive reporting by the borrower, provide more certainty as to the availability of credit, which is of utmost importance in this environment. Some very strong companies that could access unsecured credit are opting for ABL facilities to avoid any doubt about their access to working capital and to ensure capital at a good cost while they are still strong. Weaker companies often have no choice but to borrow on this basis, as their earnings are not predictable enough to warrant a loan based on cash flow. Pricing on ABL loans is also generally less costly.

**Q: Is ABL a good match for private equity firms looking to do deals, and why?**

**A:** ABL is one of the only forms of capital that is available in this market, so it is a great match for PE firms. Retail, in general, due to the cyclical nature of the business and due to the fashion risk in certain businesses, has always been difficult to finance on a cash-flow basis. The LBOs accomplished during the 2005 to 2007 period were significantly overleveraged, and many of these companies are in a difficult position as a result. Fortunately, many of these deals were structured with ABLs that still have significant liquidity at good terms to provide working capital during a downturn. In today's market, for the most part, retail acquisitions can only be accomplished with ABL and equity plus, perhaps, some long-term patient mezzanine capital. PE firms can utilize an ABL to fund some of the acquisition cost of the target company while at the same time making sure that the deal closes with enough liquidity or availability under the ABL line to meet seasonal working capital needs. Borrowing availability under the ABL facility could also fund some growth or fund some cash burn from operations if there is a turnaround element to the transaction. The lack of covenants in most ABLs enables a PE firm and management to concentrate on their business.

**Q: Are there opportunities for lenders? Clients?**

**A:** There are great refinance opportunities for lenders right now as some very established retail companies need more liquidity. Some credits that were once unsecured borrowers are now looking to the ABL market, and there is an opportunity to finance relatively strong companies and get good returns. Risk is being repriced, so refinance opportunities, whether for a distressed retailer or a stable one, have better pricing and terms. The M&A market is quiet right now, a function of the lack of cash-flow lending available and the result of an adjustment process between buyers' and sellers' expectations over purchase prices. Also, most companies are reluctant to put themselves up for sale based on recession-level performance—depressed cash flow at depressed multiples resulting in enterprise values well below what management believes is their true value in a stable economy. The M&A deals that are getting done are defensive deals—cases where a larger company is unloading a less strategic subsidiary to reinvest proceeds in or help liquefy its core business or outright distress sales. Hence there are few M&A financing opportunities for lenders in retail right now. For retailers, particularly the stronger ones, there are opportunities to pick up store locations that are being vacated by defunct players; there is more power over the vendor community. There are opportunities to renegotiate real estate leases, renegotiate other contracts. Stronger retailers can take an offensive posture in this market by taking advantage of their liquidity. ■

“ABL facilities, while requiring more comprehensive reporting by the borrower, provide more certainty as to the availability of credit, which is of utmost importance in this environment.”